No. 14623

In the

United States Court of Appeals

For the Ninth Circuit

FORREST L. MOE and EDITH B. MOE,
Appellants,

vs.

HUGH H. EARLE, Former Collector of Internal Revenue at Portland, Oregon,
Appellee.

Brief of Amici Curiae in Support of Appellee

Appeal from the United States District Court for the District of Oregon.

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FILED

OCT 20 1955

PAUL P. O'BRIEN, CLERK

PARKER PRINTING COMPANY, 180 FIRST STREET, SAN FRANCISCO 5

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Appeal from the United States District Court for the District of Oregon.

THE INTEREST OF AMICI CURIAE

This brief is presented by Marion B. Plant and Bailey Lang as amici curiae and Brobeck, Phleger & Harrison of counsel. The parties to the appeal have consented to the filing of this brief, and copies of the consents have been filed with the Court in accordance with Rule 18, Part 9 of the rules of this Court.

This appeal raises important issues in the taxation of patrons of agricultural cooperatives, and the amici curiae present this brief at the instance of several such cooperatives, namely, the Challenge Cream and Butter Association, the California Lima Bean Growers Association, the California Date Growers Association, and the California and Hawaiian Sugar Refining Corporation, Ltd.

THE QUESTIONS INVOLVED

The facts of this case raise issues concerning the tax consequences of an important method of cooperative financing.

An agricultural cooperative exists for the purpose of marketing the products of its farmer-patrons. It receives the agricultural products produced by its patrons and markets them, returning to the patrons the net proceeds of the goods so marketed.

As this Court judicially knows, one of the important techniques employed by cooperatives to finance their operations is to withhold out of the sums which would otherwise become due to the patrons certain sums for reserves and capital improvements. Typically, the cooperative issues to the patron some sort of certificate disclosing the amount withheld, and from time to time the amount so withheld by the cooperative may be paid to its patrons in redemption of the certificates.

The question presented upon this appeal is whether the patron is taxable upon the withheld sum,

(a) at the time that it is deducted from the proceeds of the sale of his products, or

(b) at the time a certificate is issued evidencing the sum withheld (which may or may not occur in the same tax year as the sum is withheld), or

(c) when the certificate is redeemed.

In the present case the taxpayers did not include the sum withheld out of the proceeds of sale of their crops in their income tax returns for the year in which the withholding was made; neither did they report it on their income tax return for a subsequent year in which a certificate was issued evidencing the withholding. They did report it as income in the year in which the certificate was redeemed.

Thereafter they brought this suit for a refund of the tax, claiming that the tax was due in the year in which the withholding was made and not in the year in which the certificate was issued nor in the year in which the certificate was redeemed. The District Court held that the tax was due for the year in which the certificate was redeemed.

Amici curiae and the agricultural cooperatives for whom they are authorized to speak believe that the District Court properly decided the case and file this brief in support of that decision.

NECESSITY FOR AN AMICUS BRIEF

The rather unusual spectacle of a group of taxpayers causing a brief to be filed in support of the government in a tax case invites some explanation.

The explanation lies in the position taken by the government on this appeal. The government in its brief has stated that the decision of the lower court must be affirmed on the authority of the decision of this Court in *Caswell's Estate v. Commissioner,* 211 F.2d 693 (9th Cir. 1954). But the government has not presented any arguments in support of the decision in the *Caswell* case but, rather, has stated that decision is contrary to the position of the Internal Revenue Service. At least by inference, it invites this Court to overrule its earlier decision and to decide this case in favor of the taxpayer.

Amici curiae and the cooperatives for whom they are authorized to speak believe that the decision in the *Caswell* case is sound and that it is a correct application of tax accounting principles to patrons of agricultural cooperatives. Since the government does not seem disposed to support the decision of the lower court, amici curiae have filed this brief in support of the principles established by the *Caswell* case and others like it.

SCOPE OF THIS AMICUS BRIEF

The facts upon which this case must be decided, as shown by the record, are that the Apple Growers Association, an Oregon corporation operating as a cooperative, withheld out of the proceeds of the sale of the taxpayers' apples certain sums in the years 1930, 1931, 1935, 1936 and 1937. In 1942 the cooperative issued to the taxpayers certificates evidencing these past withholdings which had been placed in a Building and Equipment Fund. In 1949 the cooperative paid the face amount of certain of the certificates to the taxpayers in cash, and in 1951 it paid the face amount of the remaining certificates in cash.

The taxpayers included the cash amounts so received in their gross income for the years 1949 and 1951 which were the years in which the cash was distributed to them. They filed claims for refund of the tax paid on those amounts and sought recovery thereof in the District Court. The District Court held that the taxpayers properly included in their gross income for 1949 and 1951 the cash amounts received by them from the cooperative in those years on redemption of the certificates.

The interest of the amici curiae and the agricultural cooperatives for whom they are authorized to speak in this proceeding does not lie in the question of whether the decision should be affirmed or not. Indeed, they think it should be affirmed but that is only incidental to their real interest which lies in maintaining the broad principle that members and patrons of agricultural cooperatives are taxable upon sums withheld by the cooperative for necessary reserves and capital improvements only when the sums so withheld are paid out to the members. Conversely, they are interested in maintaining the proposition that the member-patron is not taxable upon the sums so withheld in the

year in which they are withheld or in the year in which certificates may be issued evidencing the amounts withheld.

THE STATUTES INVOLVED

Internal Revenue Code of 1939:

"Sec. 22. *Gross Income.*

(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *" (26 U.S.C.A. 1952 ed. Section 22)

Internal Revenue Code of 1939:

"Sec. 42. *Period in Which Items of Gross Income Included.*

(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period * * *" (26 U.S.C.A. 1952 ed. Sec. 42)

DISCUSSION

We discuss, in turn, the considerations determining whether the sums withheld by a cooperative are taxable to patrons (a) in the year withheld; (b) in the year in which certificates are issued; or (c) in the year such withheld sums are paid to the patrons.

I. SUMS WITHHELD BY A COOPERATIVE FOR RESERVES ARE NOT TAXABLE TO PATRONS IN THE YEAR OF WITHHOLDING.

The patrons have not received the sums withheld. Why then should they be taxed as though they had? Taxpayers here advance three contentions to justify such a result.

(a) The first contention is that the cooperative received the proceeds of the sale of the members' products, not as owner, but as the agent or trustee for taxpayers, or as a mere conduit for the money—hence receipt by the cooperative is receipt by the members.

(b) The second contention is that the amounts withheld by the cooperative and added to the Building and Equipment Fund were constructively received by the members in the years such amounts were withheld.

(c) The third contention is that the members derived an economic benefit from retention of the portion of the proceeds added to the Building and Equipment Fund by the cooperative and therefore realized income in the years that such withheld sums were added to that fund.

These contentions will be discussed separately below.

A. The Conduit Theory Is Not Applicable to the Sums Lawfully Withheld, and Even if That Theory Were Applicable it Would Not Require That the Sums Withheld Be Included in the Gross Income of Members Until Made Available to Them.

1. THE MEMBERS DID NOT RECEIVE THE FULL PROCEEDS OF SALE AND THEN INVEST A PORTION IN THE BUILDING AND EQUIPMENT FUND.

Taxpayers contend that the Association was a mere conduit or agent for the net proceeds received by it from the sale of their fruit. This contention is set forth at page 14 of their brief as follows:

> "The cooperative here sold fruit grown and delivered to it by the taxpayers, and was obligated under its

> patronage contract to pay to the taxpayers the sales proceeds less only the cooperative's operating expenses. The taxpayers, however, had agreed as members of the cooperative to the by-law requirement that certain sums, based upon the amount of their fruit handled by the cooperative, be paid each year to a capital fund * * *. Rather than insist upon full cash payment to them of the full net sales proceeds to which they were entitled, only to pay back to the cooperative the charges for the capital fund, the taxpayers acquiesced in the cooperative's application of a portion of those proceeds in satisfaction of the charge for the capital fund. *In legal effect, the taxpayers received the full net proceeds of the fruit, and thereupon invested a portion thereof in the capital of the cooperative.*" (Emphasis added.)

This contention is, in fact, the heart of the taxpayers' position.

A similar contention was made in the case of *Commissioner v. Carpenter,* 20 T.C. 603 (1953) *affirmed* 219 F.2d 635 (5th Cir. 1955) where the court describes the government's contention as follows:

> "* * * the Cooperative was under an obligation to distribute patronage dividends here in cash or certificates; * * * *The petitioner should be treated as if he had actually received the dividends in cash and reinvested the cash in the Cooperative.*" 20 T.C. 603 at 606. (Emphasis added.)

The Tax Court rejected this contention. On appeal to the Court of Appeals for the Fifth Circuit, 219 F.2d 635, 636, the Commissioner renewed his contention. Again it was rejected. It should be rejected here. We submit also that the contention assumes facts which are simply contrary to the facts of this case.

Taxpayers' rights *vis-a-vis* the Association are determined by two documents: the Standard Cooperative Growers Contract, and Section 7 (since repealed and replaced) of the Association's by-laws (Appellants' Br. pp. 21, 24). *The contract is made subject to the by-laws of the Association and hence, in effect, incorporates these by-laws by reference* (Appellants' Br. p. 22).

The contract provides for deductions for operating expenses from the proceeds of a grower's fruit, in arriving at the "net proceeds" to which he is entitled. While there is no specific mention in the contract of a deduction for the Building and Equipment Fund, there is a reference to the rules and regulations of the Association (Appellants' Br. p. 22) which would include its by-laws. Section 7 of the by-laws provides that the fund in question "is hereby created", and that an amount to be determined each year by the board of directors within certain limitations shall be "raised" (R. 56-57).

Taxpayers argue that they, the growers, were entitled to demand from the Association under the contract the full proceeds of sale without deduction of any amount for the Building and Equipment Fund even though they would be required, under Section 7 of the by-laws, to pay the identical amount to the Association as a contribution to the Building and Equipment Fund. In making this argument appellants overlook several pertinent points.

(a) *First,* This was one agreement, not two, because the grower contract incorporates and is made subject to the by-laws (Appellants' Br. p. 22). As a matter of general law, moreover, the contract would be deemed to incorporate the provisions of the by-laws whether or not this is done expressly. *Hayden v. Franklin Life Ins. Co.,* 136 F. 285 (8th Cir. 1905). Thus the rights of the growers under the con-

tracts are as much restricted by limitations found in the by-laws as by limitations appearing on the face of the contract.

(b) *Second,* the uniform practice of the parties was to raise the fund by means of deductions from the proceeds of the growers' fruit. Findings of Fact X (R. 58-59); Testimony of Robert B. Barker, Treasurer of the Association (R. 128-29). Thus the by-laws were construed in practice as permitting the board of directors to withhold from the proceeds amounts needed for additions to the Building and Equipment Fund. This is the obvious and natural way to raise such a fund.

(c) *Third,* this practical construction which the parties put upon their agreement is legally binding upon the members. It has been so held many times in a line of authority dating from *State ex rel. Farrell v. Conklin,* 34 Wis. 21 (1874). In that case, it was unclear from the by-laws whether the board of directors was authorized to hold meetings at other than a certain hour. The pleadings alleged that meetings had repeatedly been held at other hours, and the court said:

> "* * * the practical construction put upon the by-law * * * must prevail * * * the facts admitted by the demurrer *bind the court to the practical construction of the by-laws given by the members of the society themselves, in acting upon it.*" 34 Wis. 21, 32. (Emphasis added.)

More recent cases to the same effect are, e.g., *Peters v. Minnesota Department of Ladies of G.A.R., Inc.,* 239 Minn. 133, 58 N.W. 2d 58 (1953); *Joy v. Ditto, Inc.,* 356 Ill. 348, 190 N.E. 671 (1934). It seems clear, therefore, that the growers could *not* have enforced payment to them of the sums deducted for the Building and Equipment Fund.

(d) *Fourth,* the Oregon laws explicitly contemplate and sanction a withholding for reserves, rather than full payment followed by investment in a "capital" fund:

> "* * * The sums remaining for distribution to the members after paying operating expenses *and deducting sums for reserves* * * * shall be apportioned as dividends * * *". Ore. Rev. Stat. § 62.310 (1953)

(e) *Fifth, this very by-law* has been construed by the courts of the State of Oregon and been interpreted by them not to allow the members to recover from the Association amounts added to the Building and Equipment Fund. See *Davidson v. Apple Growers' Association,* 159 Ore. 474, 79 P.2d 991 (1938). In that case, a grower demanded money from the Association on several theories. The court held:

> "It is an admitted fact that defendant deducted from the proceeds of the fruit crops in suit, for the nine years involved, the total sum of $16,977.69 for its *building and equipment fund.* That is less than four cents upon each of the 435,114 packages delivered by * * * [the growers]. The members by-laws authorize a deduction of from 'nothing to five cents per package.' *Plaintiff has no ground of recovery in that respect.*" 79 P.2d 991 at 997-98 (Emphasis added.)

The contrast between legal theory and the actual facts is well illustrated by the transcript of testimony. Counsel for appellants contended:

> "They [the growers] could have gone into the association and said, 'Here, our contract requires you to pay us the full net proceeds of our fruit without holding out anything for the Building and Equipment Fund.' They could have done that, and they would have prevailed, and the association would then have said, 'Okeh, but you owe us $140 for the Building [74] and Equipment Fund.' They would have just exchanged money." (R. 148)

Against this contention by counsel stands the testimony of Appellants' own witness, Robert B. Barker, treasurer of the Association, on cross-examination:

> "Q. In other words, the only right he [the grower] had to draw was the balance as shown on the account; is that correct?
>
> A. That is correct.
>
> Q. He did not have any right to withdraw the amount which had been deducted for the Revolving Capital Fund[1] account, did he?
>
> A. *He did not.*
>
> Q. He did not have any right to withdraw any amount which had been deducted for operating expenses?
>
> A. He did not." (R. 158) (Emphasis added.)

In support of their position that the cooperative was required to remit to them the proceeds from the sale of the fruit without deduction for additions to the Building and Equipment Fund, the taxpayers cite *Hood River Orchard Co. v. Stone,* 97 Ore. 158, 191 P. 662 (1920). Taxpayers point out in their brief, however, (Appellants' Br. p. 12) that the *Hood River Orchard Co.* case was decided prior to the time the by-law establishing the Building and Equipment Fund went into effect. Hence that case clearly does not support the taxpayers' position.

The growers had no more right to demand the sums withheld for the Building and Equipment Fund than they did the amounts withheld for operating expenses. Yet no one, least

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1. While the reference here is to the "Revolving Capital Fund", it is clear that the parties understood they were discussing the Building and Equipment Fund. Mr. Barker was being cross-examined regarding Exhibit 7 (R. 157) which referred to the growers ledger account discussed on direct examination in relation to the Building and Equipment Fund (R. 134-135). Also Mr. Barker stated it to be his understanding that the revolving capital fund includes the Building and Equipment Fund (R. 131).

of all Appellant growers, would contend that amounts withheld for expenses were income to the growers in the year withheld from their gross receipts. The growers had no dominion over these amounts; they were not entitled to demand them from the Association.

2. THE CONDUIT THEORY WOULD NOT, IN ANY EVENT, REQUIRE THE INCLUSION OF THE SUMS WITHHELD IN THE MEMBERS' GROSS INCOME.

Taxpayers rely on the cases of *San Joaquin Valley Poultry Producers Assn. v. Commissioner,* 136 F. 2d 382 (9th Cir. 1943); *United Cooperatives, Inc. v. Commissioner,* 4 T.C. 93 (1944); *Harbor Plywood Corporation v. Commissioner,* 14 T.C. 158 (1950), *aff'd.,* 187 F. 2d 734 (9th Cir. 1951); *Bradshaw v. Commissioner,* 14 T.C. 162 (1950); and *Midland Cooperative Wholesale v. Commissioner,* 44 B.T.A. 824 (1941).

Appellants cite the foregoing cases in support of a so-called "conduit" theory to the effect that the net proceeds of sale by the cooperative belong to its members. The conduit theory as developed in these cases, however, has to do with the taxation of cooperatives rather than their members. It allows certain allocations made to members to be excluded from the income of the non-exempt cooperative. The "conduit" theory has nothing to do with taxation of *members* and its application to members was rejected in the recent case of *Commissioner v. Carpenter,* 219 F. 2d 635 (5th Cir. 1955).

In the *Carpenter* case the Commissioner of Internal Revenue argued that the "conduit" theory applied to the facts involved in that case and that therefore the certificates there issued to the members pursuant to a pre-existing obligation were required to be included in the income of the

members. The Tax Court in that case (20 T.C. 603 (1953)) replied to this argument by stating that (20 T.C. 603, 607):

> "The cooperative and its patrons are different entities and we do not think it necessarily follows that *what is excludable from the income of the cooperative, whether the cooperative be taxable or tax exempt, automatically becomes income to the member* * * * We confine ourselves to the problem before us. Is the petitioner here taxable on any amount represented by the certificates issued by the cooperative? The import of the decisions is that the member is not taxable unless the certificates have fair market value." (Emphasis added.)

This Court in the case of *Caswell's Estate v. Commissioner,* 211 F. 2d 693 (9th Cir. 1954) likewise held that certificates issued to members of a cooperative were not taxable income to those members in the year issued to them. In that case this Court held that the certificates were not income for the reason that the rights evidenced by the certificates were subject to certain contingencies which so qualified the probability of any realization of cash by the members as to make it improper to impose a tax upon the receipt of the certificate.

The case of *Farmers Grain Dealers Ass'n. of Iowa v. United States* (S.D. Iowa 1953) 116 F. Supp. 685, *appeal dismissed,* 214 F. 2d 350 (8th Cir. 1954) is in accord with the decision of *Caswell's Estate v. Commissioner.* The District Court in that case held that the certificates issued to members, even though they were on the accrual basis of tax reporting, were not income to those members. The District Court found that redemption of the certificates was dependent upon a distribution by the cooperative of a

contingency reserve in the discretion of the board of directors.

Also in accord with the foregoing cases is *Halladay v. U. S.*, Volume 5 CCH 1955 Fed. Tax. Rep. ¶ 9637 (D.C. S.D. Calif. July 29, 1955) which holds that sums credited to the taxpayers' account in the revolving fund maintained by the Placentia Mutual Orange Association were not includable in the taxpayers' income.

The *Carpenter, Caswell, Farmers Grain Dealers Ass'n. of Iowa* and *Halladay* cases appear to us to be entirely correct and to be in accord with decisions of the Tax Court dealing with related issues. See *San Francisco Stevedoring Co. v. Commissioner,* 8 T.C. 222 (1947).

3. THE VACILLATION OF THE GOVERNMENT ON THE TAXATION OF MEMBERS OF COOPERATIVES.

The Government asserts in its brief (Appellee's Br. p. 8) that the *Carpenter* and *Caswell* decisions are "contrary to long established administrative practice of the Internal Revenue Service." It becomes apparent upon an examination of prior rulings that the administrative practice referred to is not "long established" nor has it been consistent. The Government's inconsistent and contradictory rulings provide no talisman for the answer to this problem, much less a reason for disturbing the well considered decision of this Court in the *Caswell* case.

The Government cites I. T. 3208, 1938-2 Cum. Bull. 127, which was promulgated in 1938, as an example of an early indication of the position of the Internal Revenue Service regarding the taxability of the members of cooperatives on non-cash patronage distributions (Appellee's Br., p. 9). I. T. 3208, however, dealt with the unusual provisions of the Iowa Code relating to cooperatives, and the ruling states

that "there is a distinction between the patronage dividends here involved and the payments ordinarily termed 'patronage dividends.'" Hence the ruling was by its terms not intended by the Internal Revenue Service to be of general application.

The Iowa Code precluded the payment of ordinary patronage dividends and required that the proceeds of patronage in excess of operating expenses be retained for addition to a revolving fund. The amounts added to the fund were credited to the accounts of members. These credits were payable only on liquidation of the association unless sooner called for redemption.

The foregoing ruling is inconsistent in at least two respects with the present position of the Internal Revenue Service. In the first place the ruling held that the credits to the accounts of members were themselves income to members, and that the "stated conclusion does not depend upon the issuance of participating certificates." 1938-2 Cum. Bull. 127, 129. The Internal Revenue Service now apparently takes the position that a withholding from the proceeds of members' crops is not income until certificates are issued to the members. See Income Tax Regulations 118 (September 26, 1953) Section 39.101(12)-2(b)(3).

I.T. 3208, moreover, provided that the credit on the books of the cooperative was taxable to members to the extent of the "value thereof." 1938-2 Cum. Bull. 127, 129. The *Carpenter* case is clearly consistent with this view. The Internal Revenue Service now apparently holds, however, that the sums withheld are taxable to members in the full amount regardless of the value of the rights accruing to the members with respect to such sums. See *Carpenter,* 20 T.C. 603, 606; Income Tax Regulations 118 (September 26, 1953) Section 39.23(a)-23(b).

The taxpayers in their brief, moreover (Appellants' Br., p. 8), make reference to a statement made by the Bureau of Internal Revenue to the president of the Apple Growers Association in the early 1940s and subsequent to the promulgation of I.T. 3208 to the effect that only cash distributions from the cooperative should be reported for income tax purposes.

Only as late as 1950 did the Internal Revenue Service appear for the first time to adopt the position that all non-cash patronage distributions in the form of capital stock or otherwise were taxable in full to the members of cooperatives to the same extent that such distributions would be taxable if paid in cash. *Income Tax Information Release No. 2,* dated April 13, 1950, set forth in Paragraph 6111 of Volume 5 of the CCH 1950 Federal Tax Reporter. Formal regulations adopting this policy were not issued until May 29, 1953. See T.D. 6014, 1953-1 Cum. Bull. 110. This policy is hardly, therefore, "long established."

As recently as the decision in the *Caswell* case (1954), moreover, the Commissioner has advanced views which are inconsistent with those set forth in the foregoing Income Tax Information Release. In proceedings before the Tax Court in the *Caswell* case itself the Commissioner of Internal Revenue did not rely on the "conduit" theory nor any other theory of constructive receipt but contended that the certificates there involved should be taxable under Section 111(b) of the 1939 Internal Revenue Code *to the extent of their fair market value.* 17 T.C. 1190, 1198. Yet in the *Carpenter* case the Commissioner argued before the Tax Court "that the revolving fund certificates should be taxable at their face amount *regardless of whether or not they had any fair market value at the time of their issuance.*" 20 T.C. 603, 606 (emphasis added). Hence, over the years and until very

recently the position of the Internal Revenue Service has varied considerably regarding the taxability of non-cash patronage distributions.

Indeed, the record in the present case fully demonstrates the inconsistent position frequently taken by the Commissioner with regard to this issue. In this case, the Commissioner included certificates in the taxpayers' income for the year 1949 but yet contends in this case that the receipt of cash is the taxable incident. See Appellants' Br., pp. 7-8. Thus the Commissioner seems to be endeavoring to tax the cash and the certificates as well with respect to this particular taxpayer.

4. RECENT CASES ARE DIRECTLY CONTRARY TO THE CONTENTION OF APPELLANTS.

Apart from all of the foregoing, the taxpayers here are contending that the net proceeds from the sale of the fruit should be includable in their income even prior to the time when certificates are issued to them by the cooperative. It will be recalled that it is the position of the taxpayers that the income should be included by them in the years 1930, 1931 and 1935 through 1937 rather than in the year 1942 when the certificates were issued, or in the years 1949 and 1951 when the certificates were redeemed in cash. The position of the taxpayers is therefore inconsistent with the recent case of *William A. Joplin, Jr. v. Commissioner,* 17 T.C. 1526 (1952). In this case the taxpayer argued that the balance added to reserves by the cooperative, for which no certificates or any other evidences of indebtedness were issued, were includable in his income in the year the net proceeds were received by the cooperative and added to the reserve. This is essentially the same contention that is being made in the instant case. The Tax Court held that the sums

added to the reserves were not income to the taxpayer in that year. *George Bradshaw v. Commissioner,* 14 T.C. 162 (1950) and *Halladay v. U. S.,* Volume 5 CCH 1955 Fed. Tax Rep. ¶ 9637 (D.C. S.D. Calif. July 29, 1955) are to the same effect.

B. The Sums Withheld Were Not Constructively Received by the Appellants in the Years of Withholding.

The contention of the taxpayers (Appellants' Br., pp. 15-16) that they constructively received the sums added by the Association to its Building and Equipment Fund in the years 1930, 1931 and 1935 through 1937 is essentially the same contention as was made under the "conduit" theory which has been discussed previously in this brief. Thus, the taxpayers state (Appellants' Br., p. 16):

> *"The taxpayers could have demanded and enforced payment of the full net proceeds, without deduction of any capital fund charge.* The taxpayers were not obliged to, but did, acquiesce in the cooperative's practice of setting off against its obligation to the taxpayers to pay them the net proceeds of their fruit, their obligation to the cooperative to contribute to the Building and Equipment Fund. There was thus a constructive receipt of income to the taxpayers in the amount which they were entitled to receive in cash but which they permitted voluntarily to be applied upon their obligation to the capital fund." (Emphasis added.)

We have pointed out previously that the application of this theory to this case is simply unwarranted by the facts.

The reasons why taxpayers' assertion that they "could have enforced payment of the full net proceeds, without deduction of any capital fund charge" is contrary to the facts will be summarized below.

(a) *First,* there were *not* two separate obligations, one arising out of the growers contract and entitling the members to the full net proceeds, and the other arising out of Section 7 of the by-laws (R. 56-57) and requiring the members independently to "contribute" to the Building and Equipment Fund. The growers contract incorporated the by-laws by reference. (Appellants' Br. p. 22). Hence there was but one contractual obligation which was subject to Section 7 of the by-laws and the Association's right to withhold for the Building and Equipment Fund.

(b) *Second,* the consistent practice of the Association and the members was to raise the fund by means of deductions out of the proceeds from the sale of fruit. Findings of Fact X (R. 58). This course of conduct was a practical interpretation of Section 7 of the by-laws which established the fund (R. 56-57) and was legally binding on the members of the Association. *State ex rel. Farrell v. Conklin,* 34 Wis. 21 (1874).

(c) *Third,* the highest court of the State of Oregon has construed Section 7 of the by-laws as denying to members of this Association the right to recover amounts withheld for addition to the Building and Equipment Fund. *Davidson v. Apple Growers' Association,* 159 Ore. 474, 79 P.2d 991 (1938). This construction of the grower contracts and by-laws should be and is binding on the Appellants in this case. *Gallagher v. Smith,* 223 F.2d 218 (3rd Cir. 1955).

(d) *Fourth,* the Oregon Statutes permit a withholding from the proceeds received by the cooperative of amounts added to reserves. *Ore Rev. Stats.,* Section 62.310 (1953).

(e) *Fifth,* the testimony of the Association's treasurer in the District Court indicates that the members had no right to withdraw amounts which had been deducted for reserve funds (R. 158).

There is, finally, no evidence in the record which factually supports the Appellants' legal theory. The burden of proof was plainly on Appellants to establish a factual basis for the legal theory relied upon.

For all of the foregoing reasons the cases relied upon by Appellants to support their constructive receipt theory are not in point.

The case primarily relied upon by Appellants is *Acer Realty Co. v. Commissioner,* 132 F.2d 512 (8th Cir. 1942). In that case the tenant in taxpayer's building had advanced $10,500 to the taxpayer. The rental which it was obligated to pay taxpayer was $18,000 per year subject to an increase if certain additional building was completed during the year. The tenant paid $9,300 during the year as rent and it was then agreed that the taxpayer would offset against the additional rent due its liability due the tenant. The entries carrying out this understanding were not made until the following year. It was held that the taxpayer constructively received the rental income even though the book entries had not been made. The Board of Tax Appeals found that: "The offset of one debt against the other was intended and petitioner had an absolute right to make it during the tax year." 45 B.T.A. 333 (1941) at 339. This finding was affirmed on appeal.

In the present case there are no separate debts which could be set off against each other. There is one contract, the growers contract, which during the years in question was subject to the by-laws; and Section 7 of the latter (R. 56-57) precluded the taxpayers from recovering amounts added to the Building and Equipment Fund.

Commissioner v. Scatena, 85 F.2d 729 (9th Cir. 1936) merely deals with the year in which a stock dividend was unqualifiedly subject to the demand of a stockholder so as to be included in that stockholder's gross income. It is not clear

in what respect this case supports the Appellants' position.

In *Herbert v. Commissioner,* 81 F.2d 912 (3rd Cir. 1936) the taxpayer was held taxable on a dividend which was, at his request, applied against his indebtedness to the corporation. This case is distinguishable from the present one for the same reasons given above in connection with the *Acer Realty Co.* case. *William B. Grise v. Commissioner,* 6 B.T.A. 743 (1927) is similarly distinguishable.

In short, the Appellants rely on authorities and on a legal theory which finds no factual support in the present record. They artificially reconstruct separate debts out of a contract right which the record shows to be indivisible. That contract right, moreover, has been judicially interpreted to entitle them to the net proceeds from the sale of their fruit *after* the deduction of additions to the Building and Equipment Fund. *Davidson v. Apple Growers' Association,* 159 Ore. 474, 79 P.2d 991, 997-998 (1938).

C. Members Realize No Such Economic Benefit as to Justify Inclusion in Their Gross Income of Sums Withheld for the Building and Equipment Fund.

This contention by the taxpayers (Appellants' Br. pp. 16, 17) reiterates to some extent their same argument to the effect that the right of the growers to receive the full net proceeds from their fruit was separate from their obligation to contribute to the Building and Equipment Fund. Thus the taxpayers contend that "in return for the application of their money to the Building and Equipment Fund" they received "the benefit of the discharge of their obligation to contribute to that fund" (Appellants' Br. p. 16). For reasons discussed at length elsewhere in this brief and which will not therefore be repeated here, this argument has no factual support whatsoever in the record.

The taxpayers contend also, however, that they derived an economic benefit from the "Building and Equipment Fund credits to their account on the books of the cooperative which entitled them to their pro rata share of the proceeds of the cooperative's assets in the event of dissolution or sale of the cooperative (Ex. 13, p. 13; Ex. 3, 4, 5, 6; R. 32)." Appellants' Br. pp. 16, 17.

But it is clear that the members of the Association derive no more "economic benefit" from an investment by the Association of a part of the proceeds of the sale of crops in plant and equipment than is derived by the ordinary shareholder of a corporation from the investment by that corporation of its retained earnings. Yet it never has been successfully contended that the shareholder of an ordinary corporation receives taxable income prior to the time dividends are paid or declared in cash or property. Such a contention was rejected many years ago. *S. R. Kelsey v. Commissioner,* 6 B.T.A. 1068 (1927).

Also rejecting the contention that the credits themselves are income is the case of *William A. Joplin, Jr. v. Commissioner,* 17 T.C. 1526 (1952).

Taxpayers cite the case of *Helvering v. Horst,* 311 U.S. 112, 61 S.Ct. 144 (1940). This case deals with the taxability to the donor of intra-family assignments of income. The "economic benefit" theory that it propounds is not therefore applicable in this case.

II. CERTIFICATES EVIDENCING THE SUMS WITHHELD ARE NOT INCOME TO THE MEMBER IN THE YEAR IN WHICH ISSUED.

The District Court held that the certificates issued to the taxpayers in 1942, evidencing withholdings in prior years, were not income to them in 1942. Such a holding was a necessary corollary to the holding of the District Court that the

cash received by the taxpayers in 1949 and 1951 upon redemption of the certificates was taxable income in the years of payment.

If the certificates were includable in the gross income of the taxpayers in 1942 then the taxpayers would be entitled to a tax basis for these certificates equal to the amount properly includable in their 1942 income, and this basis would offset the cash received in redemption of the certificates in 1949 and 1951. Thus in the case of *Ross v. Commissioner,* 169 F.2d 483 (1st Cir. 1948) the taxpayer had been credited with salary earned during the years 1927 through 1932. The withdrawal of the salary so credited was restricted until April of 1932. The taxpayer did not report the salary as income in his return for 1932, however, and when a part of that salary was actually withdrawn in cash in 1939 the Commissioner endeavored to include it in the taxpayer's gross income for that year. The Court of Appeals held that since the income was properly includable in the taxpayer's income in 1932 it was not includable in any subsequent year.

The District Court was correct therefore in specifically undertaking to decide the question of whether the certificates issued to the members in 1942 were taxable income to them in that year.

A. The Rights Evidenced by the Certificates Were Subject to Contingencies Which Preclude Their Inclusion in Taxpayers' Income.

The District Court in holding that the certificates were not taxable income follows the decision of this Court in *Caswell's Estate v. Commissioner,* 211 F.2d 693 (9th Cir. 1954) as well as the decisions by the Court of Appeals of the Fifth Circuit and the District Court for the Southern District of Iowa in the cases of *Commissioner v. Carpenter,* 219 F.2d

635 (5th Cir. 1955) and *Farmers Grain Dealers Ass'n of Iowa v. U. S.,* 116 F. Supp. 685 (S.D. Iowa 1953) *appeal dismissed* 214 F.2d 350 (8th Cir. 1954).

For the face amount of the certificates to be includable in the income of the cash-basis taxpayers they would have to represent cash or the equivalent of cash. Section 42(a) of the 1939 Internal Revenue Code, 26 U.S.C.A. 1952 ed. Section 42. To be the equivalent of cash, income must be "credited to the account of or set apart for a taxpayer" and must be such that it "may be drawn upon by him at any time." Income Tax Regulations 111, Section 39.42-2 (October, 1943).

It is well settled, of course, that any restrictions placed on the withdrawal of money by a cash-basis taxpayer preclude the constructive or other receipt of that income for tax purposes. See *Francis Metal Door and Window Corp. v. Commissioner,* 178 F.2d 405 (2nd Cir. 1950), *affirming* 7 CCH Tax Court Memorandum Case 755; *Charles M. Howell v. Commissioner,* 21 B.T.A. 757 (1930); *R. V. Board v. Commissioner,* 14 B.T.A. 374 (1928).

Thus in the *Francis Metal Door and Window Corp.* case the petitioner corporation set up on December 31, 1942 reserves in its ledger accounts designated "Reserve for Deferred Salaries" and "Reserve for Deferred Obligations." The amount set up in the former reserve represented the 1942 salary of two officers. Those officers had verbally agreed with a bank which had loaned money to the petitioner to receive only $75.00 per week while the loan was unpaid. It was held that the salary credited to the reserve was not received by the officers for income tax purposes since its withdrawal by them was restricted. Said the Tax Court (7 CCH Tax Court Memorandum Case 755, 759):

> "To say that the items entered into these reserve accounts were during 1942 'made available' * * * so that

> they might 'be drawn at any time' * * * is a direct contradiction of terms in association with the word 'reserve.' "

The foregoing case was affirmed *per curiam* by the Court of Appeals for the Second Circuit. 178 F.2d 405 (2nd Cir. 1949).

It is clear that the certificates issued to the Appellants in 1942 were not the equivalent of cash nor could the amounts designated in the certificates be withdrawn by them at will. The certificates provided on their face (Appellants' Br. p. 6) that they would be refunded "when and if the Board of Directors shall determine to refund same." The certificates further stated that (Ex. 8, 9, 10, 11, 12):

> "The time and amount of any refund upon this certificate is and shall be within the discretion of the Board of Directors of Apple Growers Association and the rights hereunder are and will be governed by the members' by-laws of said Association and the holder hereof will and does accept same subject to those conditions and with that knowledge."

Thus payment of the certificates was clearly contingent on action taken at the discretion of the Board of Directors of the Association in redemption of them.

It was held in the *Farmers Grain Dealers Ass'n of Iowa* case (116 F. Supp. 685), cited above, that the certificates there involved were not includable in the income of an accrual basis taxpayer. The District Court held that the taxpayer in that case "should not be compelled to accrue as income an amount which is unsettled or the availability of which to him is so highly contingent." 116 F. Supp. 685, 688. The latter assertion is in accord with the general rule to the effect that accrual is proper only where there is "no contingency or unreasonable uncertainty qualifying the pay-

ment or receipt, as the case may be." 2 Mertens, *Law of Federal Income Taxation* (1955 ed.) 128. The Tax Court has also held that a fund, the payment of which was to be made to the intended recipients as and when the board of directors of an association administering that fund "feels that conditions permit," was not accruable as income. *San Francisco Stevedoring Co. v. Commissioner,* 8 T.C. 222 (1947).

If the certificates would not be income to an accrual basis taxpayer, *a fortiori,* they should not be income to a cash basis taxpayer.

B. The Certificates Have No Fair Market Value.

Absence of a "fair market value" for the certificates is another reason for excluding the certificates from income. *Commissioner v. Carpenter,* 219 F.2d 635 (5th Cir. 1955). It is clear that the certificates issued to the members of the Apple Growers Association in 1942 had no fair market value. Section 9(h) of the by-laws of the Association provide that (R. 64):

> "* * * Said certificates shall not be evidence of any debt, shall not bear interest, shall give no voting rights, shall become null and void if the membership under which the 'contributions' were made shall be canceled, terminated or forfeited, and shall not be negotiable or assignable except to the purchaser of the membership under which the 'contributions' were made, together with a sale and conveyance of the premises to which the membership pertains and then only by consent of the board of directors and subject to any unpaid debt or obligation of the assignor * * *"

The certificates provided on their face, moreover, that they were redeemable only as and when the Board of Directors should determine to refund the same (Ex. 8, Ex. 9, Ex. 10, Ex. 11, Ex. 12).

The certificates are therefore substantially similar to those which were held to have no fair market value in the *Carpenter* case. The Court of Appeals stated as follows regarding the certificates there involved (219 F.2d 635, 636):

> "These certificates were redeemable only in the sole discretion of the directors of the cooperative, were non-interest-bearing, were junior to all debts of the cooperative, and could be redeemed only upon written approval of the Columbia Land Bank, the mortgagee of the cooperative. The certificates admittedly had no fair market value when issued to the respondent."

In the present case the certificates were subject to a restriction on their transfer more drastic than that involved in the *Carpenter* case, and this restriction alone would deprive them of any value. The certificates themselves were not assignable nor negotiable and hence nothing could be realized upon their transfer (Appellants' Br. p. 6). It has been generally held that the inability to realize cash upon the sale or pledge of a contractual obligation deprives that obligation of any fair market value. *D. M. Stevenson v. Commissioner,* 9 B.T.A. 552, 556 (1927); *Ravlin Corporation v. Commissioner,* 19 B.T.A. 1112, 1115 (1930).

The certificates in the *Carpenter* case were at least transferable with the consent of the board of directors of the cooperative there involved. 20 T.C. 603, 605. In the present case, however, only if the premises of the taxpayers to which their membership in the Association pertains are sold and conveyed do the certificates pass to the purchaser, and even such a sale or conveyance may be made only with the consent of the board of directors of the Association (R. 64).

It appears from the testimony in the District Court, moreover, that the certificates had no fair market value (R. 102-104).

III. THE CASH REDEMPTIONS OF PAST WITHHOLDINGS WERE INCOME TO THE TAXPAYERS IN THE YEARS OF PAYMENT.

It has been shown in Part I of this brief that the sums withheld from the sale of taxpayers' fruit for addition to the Building Fund were not includable in the income of the taxpayers for the years in which withholdings were made, i.e., 1930, 1931, 1935, 1936 and 1937.

In Part II of this brief it was shown that the certificates evidencing the withholdings of prior years were not income when issued to the taxpayers in 1942.

Accordingly, the years in which the sums withheld became taxable to the members are the years in which such sums finally were paid to them.

On grounds of policy alone it would appear proper to subject the taxpayers to an income tax only when the certificates are redeemed since it is only at this time that the taxpayers receive the money with which to pay the tax. It was truthfully pointed out centuries ago that "Every tax ought to be levied at the time or in the manner, in which it is most likely to be convenient for the contributor to pay it."[2] This observation particularly holds true at the present time when severe surtax rates, both individual and corporate, render extremely burdensome the raising of cash sufficient to make timely payment of federal income taxes. This burden should not be multiplied to the extent that taxpayers are required to pay taxes on income which they have not received or which they are unlikely to receive except possibly at some vague and indefinite future time. To do so would certainly approach, if indeed it would not exceed, the scope of the Sixteenth Amendment to the Federal Constitution. Cf.

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2. Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations, Part I, "Of Taxes".*

Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920); *Caswell's Estate v. Commissioner,* 211 F.2d 693 (9th Cir. 1954) at 696, note 17.

CONCLUSION

It is respectfully submitted that the taxpayers are subject to income tax in 1949 and 1951 when certificates, issued to them in 1942 and evidencing withholdings in prior years, were redeemed by the Apple Growers Association, and that the decision of the United States District Court for the District of Oregon should be affirmed.

Dated: San Francisco, California, October 19, 1955.

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